BFFORF THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NFVILLE 0. AND DORIS C. CHAN)

For Appellants: John P. Pinhorn
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

John A. Stilwell, Jr.
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Neville 0. and Doris C. Chan against proposed assessments of additional personal income tax in the amounts of $690.60, $381.84 and $234.90 for the years 1970, 1971 and 1972, respectively. Portions of those proposed assessments resulted from adjustments to appellants' income which are no longer in dispute. For purposes of this appeal, therefore, the amounts still in controversy are $105.20, $280.56 and $68.30 for the years 1970, 1971 and 1972, respectively.

The two issues remaining for decision are: (1) whether respondent properly disallowed certain charitable contributions deductions claimed by appellants for 1970 and 1971, and (2) whether respondent's disallowance of certain interest expense deductions claimed for all three appeal years was proper.

On August 5, 1963, Neville 0. Chan (hereafter referred to as appellant) purchased a $100,000 ordinary life insurance policy (No. 1,511,963) on his life from the Phoenix Mutual Life Insurance Company. The annual premium was stated to be $2,235. The beneficiary designation of that policy is unknown. Sometime after August 5, 1963, appellant purchased a second ordinary life insurance policy on his own life (No. 1,530,743) from Phoenix Mutual. The record does not reveal eitherthe face amount or the initial beneficiary designation of that policy. Although appellant alleges that a third life insurance policy on his or his wife's life was purchased from the same insurer in late 1963 or 1964, no details about any such policy are known.

On September 1, 1964, appellant executed a "Special Settlement Agreement" with respect to Policy Mumber 1,530,743. By that agreement, appellant revoked the existing beneficiary designation and named the Southern California Association of Seventh-Day Adventists and Loma Linda University as equal and irrevocable beneficiaries of that policy. 1/ On that same date, another amendment to Policy Number 1,530,743 was executed, whereby appellant reserved the following rights with respect to the policy:

> . . . the owner may exercise the right to change the manner of applying the surplus and receive any dividends payable, under the first 'dividend option; to borrow under the'conditions described in the participating paid-up insurance option; and to elect to make the Automatic Premium Loan provision operative and to revoke any such election, without the consent of any irrevocable beneficiary.

1/ Both of these corporations are qualified charitable organizations, contributions to which are deductible under section 17214, subdivision (b), of the Revenue and Taxation Code.

In 1968 or before, appellant obtained a policy loan from Phoenix Mutual pursuant to the above quoted special provision of Policy Number 1,530,743. The loan was secured by the cash surrender value of the policy, and was used to pay the annual premium due on that policy. In 1970 Phoenix Mutual apparently permitted appellant to increase his loan by the amount of the policy's then increased cash value. According to respondent, those borrowed funds were used to cover the amount of the premium due on the policy in 1970, as well as the interest which had accrued on the earlier loan. In 1971, appellant again borrowed from Phoenix Mutual on Policy Number 1,530,743. According to respondent, that addition to the existing loan covered the entire amount of 'the premium due for 1971, plus accrued interest. In 1972, Loma Linda Universitv paid the annual premium due on the same policy, and appellant once again increased the amount of his loan to cover the interest which had accrued on the existing loan. Apparently, there was no loan repayment during the years in question.

In the joint personal income tax returns which appellant and his wife filed for the years 1970 and 1971, they claimed the amount of the premiums due in those years on Policy **Number** 1,530,743 as charitable contributions deductions. In their returns for 1970, 1971 and 1972, they claimed interest expense deductions for the interest which allegedly had accrued during those years on one or more life insurance policy loans. Respondent disallowed all of the above deductions in full, and it was that action which gave rise to this appeal'.

In reviewing the propriety of respondent's action, it must be kept in mind that income tax deductions are a matter of-legislative grace and a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416](1940).) In this regard, the burden is on the taxpayer to show by competent evidence that he is entitled to any deduction claimed. (Deputy v. du Pont, supra; Appeal of Richard T. and Helen P. Glyer, Cal. St. Bd. of Equal., Aug. 16, 1977.)

Charitable Contributions

In computing an individual's taxable income, section 17214 of the Revenue and Taxation Code allows as a deduction "contributions or gifts, payment of which is

made within the taxable year to or for the use of: [certain qualified entities and organizations]." A similar provision is contained in the federal income tax law. (Int. Rev. Code of 1954, § 170(a) (1) .) As noted earlier, it is undisputed that the Southern California Association of Seventh-Day Adventists and Loma Linda University are qualified charitable organizations within the meaning of section 17214 of the Revenue and Taxation Code.

Respondent concedes that life insurance'policies and the premiums paid thereon may be the subject of a charitable gift, if the beneficiary is irrevocably named and all rights under the policies are irrevocably assigned. (Eppa Hunton IV, 1 T.C. 821 (1943); Ernest R. Behrend, 23 B.T.A. 1037 (1931).) The disallowance of appellant's claimed charitable deductions in the amounts of the annual premiums due on Policy Number 1,530,743 was based upon respondent's conclusion that there was no irrevocable gift to the named charitable beneficiaries because their interest in that policy during the years in question was a mere expectancy. This conclusion is based upon appellant's reservation of certain rights in the policy, including the right to obtain policy loans from Phoenix Mutual. We believe that respondent's determination in this regard is correct.

It is clear that no irrevocable gift has been made for purposes of the charitable contributions deduction where the owner of a life insurance policy designates a charitable beneficiary, but retains the unlimited right to change the beneficiary. (See Mortimer C. Adler, 5 B.T.A. 1063 (1927).) Under those facts, premiums paid are not deductible as charitable contributions because, during the insured's, lifetime, 'the charitable beneficiary's interest in the policy is a mere expectancy. It is true that appellant herein had relinquished his right to change beneficiaries. For the reasons hereafter stated, however, we agree with respondent that appellant's retention of the right to borrow against Policy Number 1,530,743 also precluded his deduction of. any amount as a charitable contribution during the years in question.

A unique feature of policy loans secured by the.cash value of the standard life insurance policy is that, in fact, there is no obligation to repay the sum "borrowed". Assuming that the amount of the policy loan and accrued interest do not exceed the cash value of. the policy, any outs tanding indebtedness is merely deducted from the proceeds of the policy when the insurance becomes payable. (Vance on Insurance (3d ed. 1951) p. 645; Mowbray, Blanchard and Williams on Insurance (6th ed. 1969)

p. 315.) Appellant's retention of the right to borrow against the policy thus left him in a position to reduce, or even to totally exhaust, any value the policy might have had to the named beneficiaries prior to his death. Under those circumstances we must conclude that, as of the end of 1972, appellant had made no irrevocable gift of any valuable interest in Policy Number 1,530,743 to its charitable beneficiaries. He was therefore not entitled to the charitable contributions deductions which he claimed in the amounts of the premiums due on that policy. 2/

Interest Expense

Under the provisions of section 17203 of the Revenue and Taxation Code, a cash basis taxpayer is allowed to deduct interest paid within the taxable year on indebtedness. A similar deduction is available for federal income tax purposes. (Int. Rev. Code of 1954, § 163(a) .) Section 17284 of the Revenue and Taxation Code imposes certain limitations on the availability of that deduction where the interest expense was incurred in connection with insurance contracts. That section provides, in pertinent part:

> (a) No deduction shall be allowed for--
>
> * * *
>
> (3) Except as provided in subsection (c), 3/ any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract ... pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).
>
> Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963.

2/ In view of the foregoing, it is unnecessary for us to consider whether payment of the premiums by means of policy loans constituted actual payment, as is required for the deduction. (See Cal. Admin. Code, tit. 18, reg. 17214, subd. (a) and Treas. Reg. § 1.170-l(a) (1).)

3/ None of the exceptions contained in subsection (c) are applicable in this case.

Subdivision (a)(3) of section 17284 was added by the Legislature in 1964 to conform to an identical change in the federal law: (Int. Rev. Code of 1954, § 264(a)(3).)

Respondent's disallowance of the interest expense deductions here in question was based upon the above quoted language in section 17284. Appellant now concedes the propriety of that action insofar as the interest disallowed as a deduction related to loans on policies purchased after August 6, 1963. Appellant still contends, however, that he is entitled to interest expense deductions of $522.50, $603.25 and $684.00 for the years 1970, 1971 and 1972, respectively. He alleges that interest expenses in those amounts were incurred in connection with a loan on Policy Number 1,511,963, which he purchased on August 5, 1963, one day prior to the operative date of subdivision (a)(3) of section 17284.

If the relevant facts were as appellant alleges, we agree he would be entitled to deduct interest which he actually paid on any 'loan outstanding against Policy Number 1,511,963. Unfortunately, the record on this issue is unclear and neither party has been particularly helpful in developing'the facts for us. Other than self-serving statements, appellant has produced no evidence which would establish that he ever obtained a loan on Policy Number 1,511,963, or that he actually paid interest on any such' loan. Although appellant's representative has stated that cancelled checks and insurance company billings are available which would prove that the alleged interest was paid, no such documentary evidence has ever been presented. Furthermore, it has been suggested by respondent, and not convincingly refuted by appellant, that any interest accruing on any such policy loan was "paid" by merely increasing the amount of the loan, up to the limits allowed by Phoenix Mutual. If that was true, even if appellant had established the existence Of a loan against Policy Number 1,511,963 he would not be entitled to the interest deduction claimed, since he would have made no actual cash payment of interest during the years in question. (Keith v. Commissioner, 139 F.2d 596 (2d Cir. 1944); Albert J. Alsberg, 42 B.T.A. 61 (1940); Nina Cornelia Prime, 39 B.T.A. 487 (1939):)

Although he has been given ample opportunity to do so, we must conclude that appellant has failed to carry his'burden of proving by competent evidence that he is entitled to any part of the interest expense deductions claimed. Respondent's action in this matter must therefore be sustained.

Appeal of Neville 0. and Doris C. Chan

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Neville 0. and Doris C. Chan against proposed assessments of additional personal income tax in the amounts of $690.60, '$381.84 and $234.90 for the years 1970, 1971 and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of October , 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member